CAPITAL STRATEGIES
FINANCIAL CORPORATION
*Navigating Financial Security*

**January 24, 2020**

# Financial Markets Commentary 4th Quarter 2019


## Summary

**2019 closed on a high note for stocks as interest rate cuts fueled a speculative boom which has continued into 2020. Against a backdrop of accommodative central banks all over the globe and a somewhat more cordial relationship between the world's two foremost economic powers, investors everywhere became more aggressive. With dividends reinvested, the S&P 500 soared 31.49% on the year. 9.07% came in the fourth quarter alone. [1] Returns around the globe were almost as strong; international developed markets were up 22.49% while emerging markets were up 18.42%.[2] The outstanding returns in 2019 were somewhat surprising given the fact that corporate profits fell during the year. It's important to recognize that our market gains are increasingly dependent on corporate leverage and government reserves. We are not predicting the stock market rally's imminent end, but debt expansion like this can't go on forever.**

**That said, we are enjoying some very good times right now. Once again, the technology sector led the way. Tech soared another 14.4% during the fourth quarter to bring its full year advance to 50.3%. Communications Services (9.0% and 32.7%) and Financial Services (10.5% and 32.1%) also outperformed last year. Energy stocks only rose 11.8% last year (a good chunk of that was in the fourth quarter). Real estate and utilities rose 29.0% and 26.3% respective last year, but utilities only rose 0.8% in the fourth quarter and real estate actually lost -0.5%. It became apparent that investors were shifting from conservative stocks to more aggressive ones. This is typical late cycle behavior. [3]**

**Individual markets around the globe were also impressive. Europe was one of the better areas with a gain of 23.5%, and that improves to 25.9% if you exclude the U.K. China gained 23.7%. Among emerging markets, gains were much more varied. Russia soared 52.7%, but India only grew 7.6%. Interestingly, German stocks are negative on a two-year basis (starting from the beginning of 2018).**


[1] Standard & Poors per Morningstar Workstation

[2] International developed stocks: MSCI World ex-USA Index [net div.], Emerging market stock: MSCI Emerging Market [net div.] per Dimensional Funds

[3] Sector performance per JP Morgan 1Q2020 Guide to the Markets

**China and India were about flat. Japan and the U.K. were up single digits, while France and Brazil posted double digit gains. The latter's two-year gain of 26.6% topped even the U.S. (25.7%).[4]**

**Bonds enjoyed a strong 2019 although almost none of their return came in the fourth quarter. The anemic 0.18% return last quarter pushed the full year gain to 8.72%. Bonds were largely a story of interest rate exposure (duration). Two-year treasuries gained just 3.31% while the 30-year bond climbed 16.43%. Corporate bonds performed well across the spectrum, while mortgages, asset-backed securities and floating rate debt lagged. The lesson on the bond side was not to bet on inflation; almost everything we expected in terms of economic growth and inflation in late 2018 did not come to pass last year. The dollar fell during the fourth quarter but rose for the full year.[5]**

## Activity

**As market conditions improved and investors seemed to fully grasp that we were in "melt-up" mode, we felt it was appropriate to reduce cash levels in accounts. They're as low as we have had them in at least twenty years. Mostly we added index-type stock exposure because that is where the strength has been. We also bumped up emerging market exposure because that area tends to do better when the dollar isn't rising. We pared back exposure to the low volatility factor stock ETFs because in a strong market volatility is your friend.**

## Outlook

**U.S. stock prices rose over thirty percent last year without any gain in aggregate corporate profits. In 2018, on the other hand, corporate profits posted strong gains while stocks declined almost -6%[6]. In recent years, central bank policy has become so easy that the performance of the underlying companies in the financial indices is now less important than the interest rates by which those profits are discounted. That is an extraordinary fact when taken in the broad swath of financial history, and we have two comments about it. One, this has been going on for several years, and will likely continue in the short-to-intermediate term. Fighting the Federal Reserve is generally not a smart move. Two, the decoupling of stock prices from corporate profits is ultimately dangerous. How can one feel confident that the price they are paying for stocks is backed by something more tangible than the spirit of the times and the willingness of central bankers to continually expand the national balance sheet?**

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[4] Foreign market performance per JPMorgan 1Q2020 Guide to the Markets

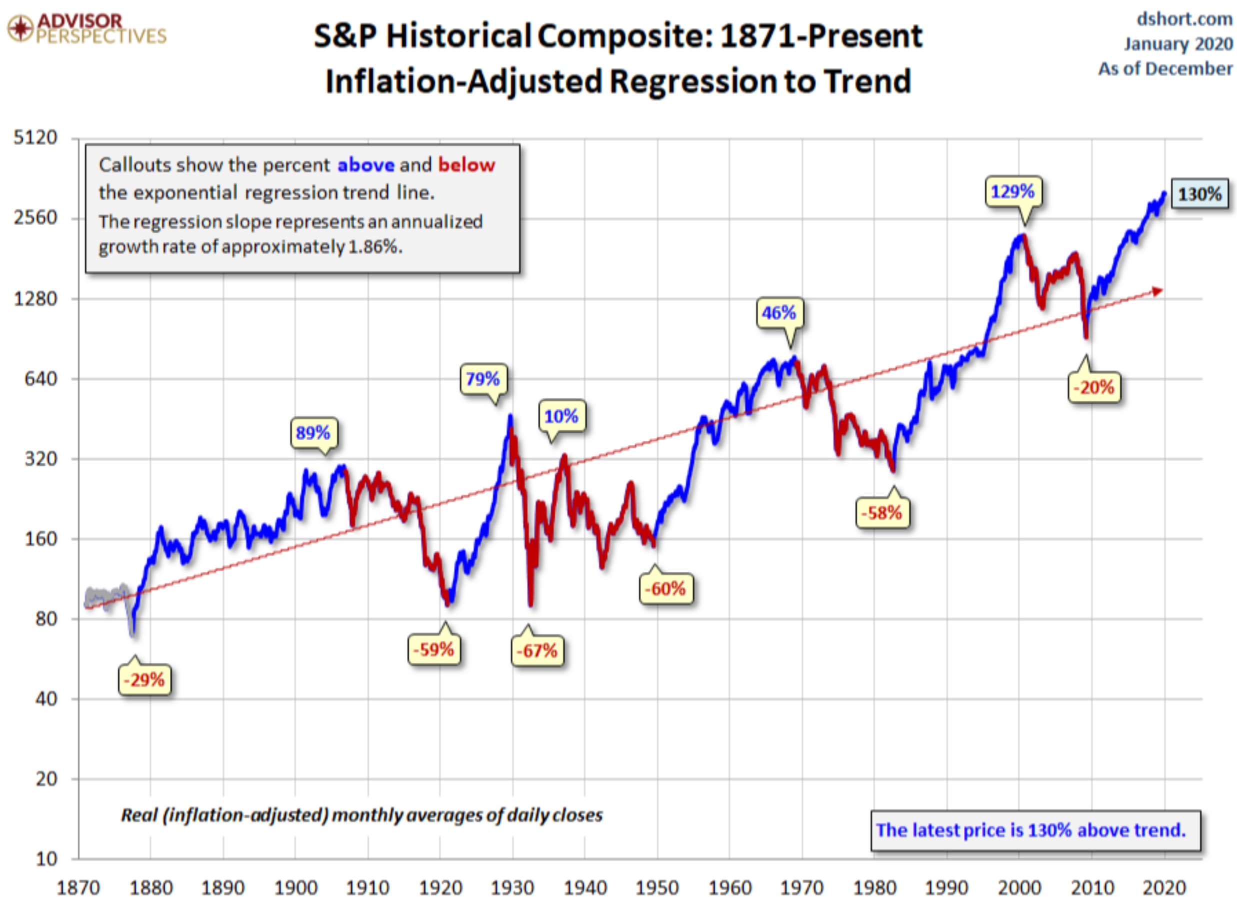
[5] Bond and currency performance per JPMorgan 1Q2020 Guide to the Markets

[6] Russell 2000 broad market performance per Morningstar Workstation

## Commentary – Our Thoughts In Chart Form

**The first chart comes courtesy of Jill Mislinski of dshort.com. It is a graph of the S&P Stock Composite Index for the last 150 years plotted against a long term trendline. Current levels are at record highs above trend. This should give one pause. That said, it may be misleading to compare valuations of today's asset-lite service economy to its asset heavy manufacturing history. Perhaps valuation should be much higher now. We would also point out that in 1997 stocks exceeded their early century highs and would go on to rally strongly for two more years. While it is hard to take anyone seriously who would argue that stocks are cheap, the current rally doesn't have to stop just because we have exceeded previous valuation peaks.**

Chart 1

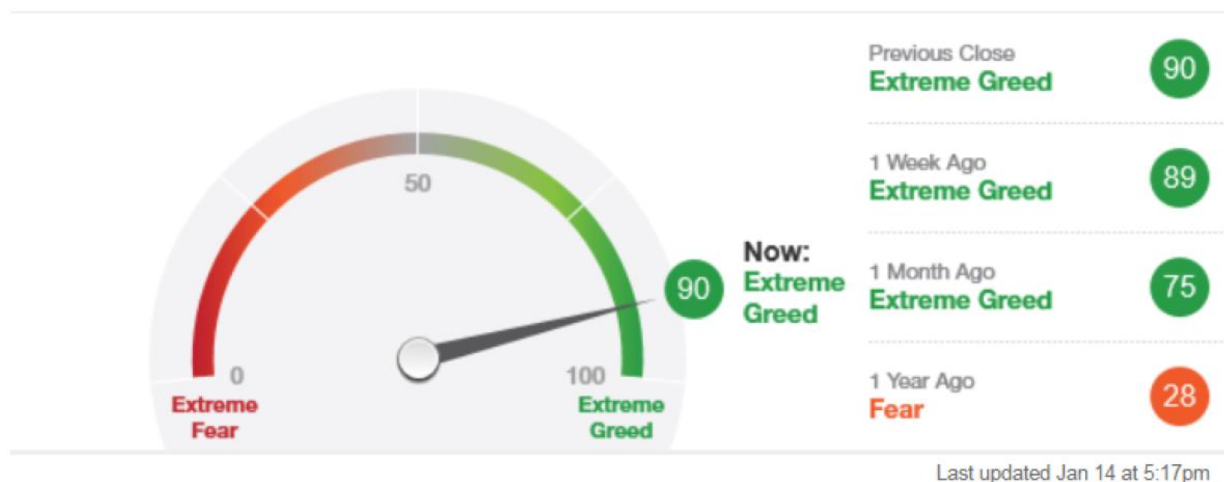


Source: A Perspective on Secular Bull and Bear Markets, Advisor Perspectives, 1/2/20

**U.S. Stocks performed very well in 2013, decently in 2014 and 2016, and very well again in 2017 and 2019. Strong stock returns do not in and of themselves suggest that sentiment has shifted so strongly bullish that a correction is imminent. In the wake of the first three of these rallies we did not see a big spike in investor bullishness. However, investors did get greedy in January 2018, which led to a "VIX crash" and a 10% pull-back. When everybody is bullish, the saying goes, there is nobody left to buy. While we don't think greed today is as pervasive as it was in 1999, we believe it is at least**

**as strong as in was in early 2018. So does Chaikin Analytics (see Chart 2). A year or so ago, when fear was peaking, it proved to be an excellent time to invest. (Note that this Greed & Fear gauge read "Extreme Fear 5" in late December 2018).**

Chart 2




Source: Chaikin Analytics, CNN.com Fear & Greed Index, 1/14/2020

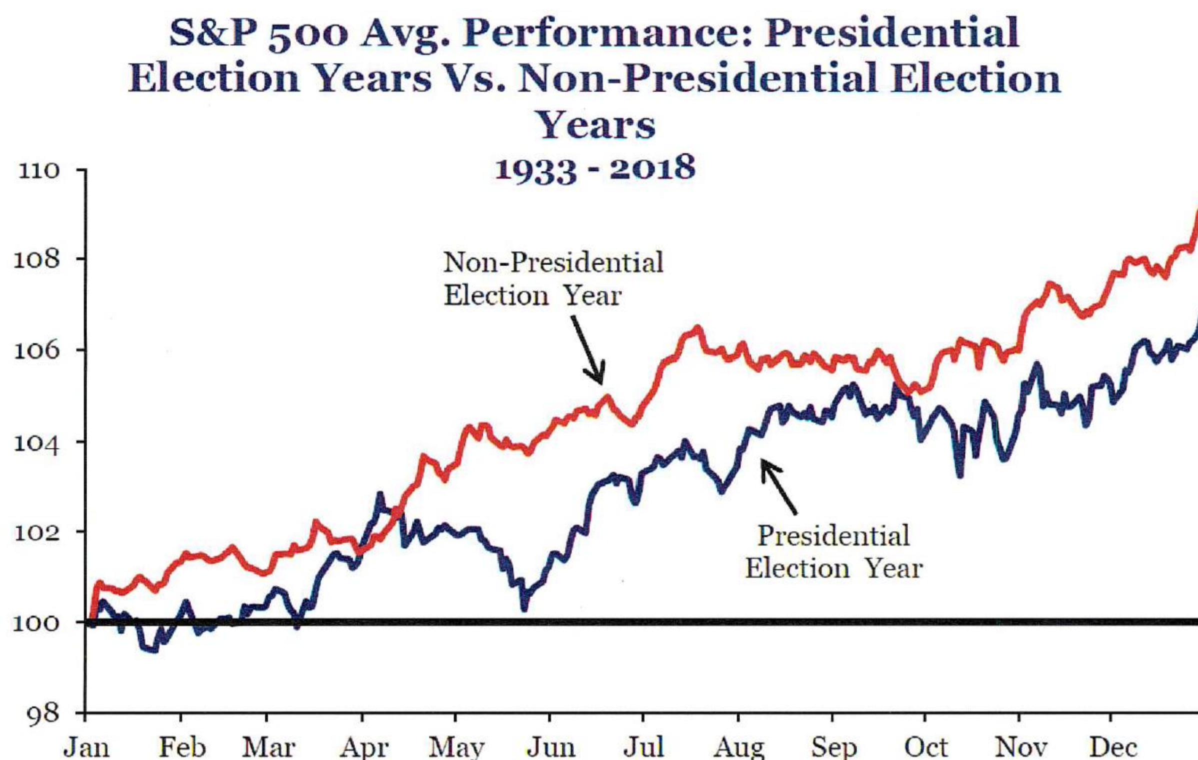
**With Alphabet's (Google) Friday close, we have now three stocks with market capitalizations above $1 trillion for the first time ever. Apple is at $1.397 trillion and Microsoft is $1.275T – each now represent greater than 4% of the S&P 500 Index. Congratulations to all of them. That said, when <u>any</u> stock has gone above 4% of the S&P 500 over the last thirty years their future performance has not been that good. This chart from the Leuthold Group makes the point that it is tough to sustain profit growth when you get above a certain size. Just some food for thought now that both Apple and Microsoft are in this category and Alphabet and Amazon are not far away.**

Chart 3

Source: Jayonthemarkets.com/2019/12, The Leuthold Group

**The final chart is of stock market performance in presidential election years and non-election years. In general, as you can see, stocks prefer non-election years. Election years also tend to see market gains, just smaller ones. There tends to be a sell-off in the spring as investors start focusing on the election in earnest and then another one in the month or two leading up to election day where uncertainty is at its highest. Once that uncertainty is removed, the stock market almost always performs well. There are, of course, no guarantees. Both 2000 and 2008 were election years, and things didn't go all that well as you'll recall. This chart merely shows that there are patterns that would be expected to prevail IF (and this is a big IF), they aren't overwhelmed by larger issues.**

Chart 4



Source: Strategas, Fidelity Investments, 11/4/2019

**<u>Our portfolios are currently on the aggressive end of the appropriate ranges, consistent with our client's various risk tolerances</u>. Yet knowing that most others <u>are positioned similarly makes us nervous</u>. If you think we should be taking more risk right now, ask yourself this: if market spirits change in a hurry, how is everybody going to get more defensive in an orderly manner? In other words, in an environment where most investors are fully committed, who does the buying if there is a mad rush to get out? We remain cautious & watchful.**

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